Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:HOU:TL-N-6008-99
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date: December 20, 1999

to: Chief, Examination Division, Houston District
Attn: Susan Stanley, Manager, Group 1406, Stop 4406 HOU

from: District Counsel, Houston District, Houston

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ubject: [redacted]

TIN: [redacted]
Taxable Year Ending [redacted]

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You requested our opinion regarding whether the above taxpayer should allocate a deduction relating to exercised employee stock options to foreign source income. Based on the facts you provided and the authorities cited below, we conclude that the taxpayer should allocate this deduction between domestic and foreign source income.

This is a large business examination case which involves a deduction of $[redacted]. The issue may be considered potentially significant to tax administration because it frequently arises in the audit of international issues. The revenue agent intends to circulate a copy of this advice to other agents who are examining other taxpayers with this issue. The advice in this memorandum is subject to modification by the Assistant Chief Counsel (Field Service) who will respond to an information copy of this memorandum, pursuant to CCDM (35)3(19)4.

UNDISPUTED FACTS

[redacted] (taxpayer) operated [redacted] and [redacted] countries during [redacted] (taxable year in issue). The foreign operations were foreign branches of the taxpayer, rather than controlled foreign corporations. Both domestic and foreign operations were supervised by the taxpayer's domestic-based executives.

During the past several years the taxpayer had granted several key executives nonqualified stock options.[1] During the taxable year in issue, several of the executives exercised their rights to the stock options, resulting in wage income to them and a compensation deduction by the taxpayer, pursuant to I.R.C. § 83(a) and (h) for the taxable year in issue.

For purposes of determining foreign source taxable income, the taxpayer allocated its deduction for employee salaries (including executives) to foreign source income by the percentage of [redacted] cost to the total [redacted] cost, with the balance allocated to domestic source income. The taxpayer, however, did not allocate its deduction relating to exercised stock options to foreign source income; instead, it applied this deduction solely to domestic source income. Minimizing the deductions to foreign source income generally increases foreign source taxable income and increases the foreign tax credit advantageous to the taxpayer. See I.R.C. § 901, et. seq.

The taxpayer argues that the stock option deduction should not be allocated to foreign source income for the following reasons:

(1) The purpose of the stock options was to give the taxpayer a significant advantage in attracting, retaining and motivating key employees. The options do not compensate employees for work performed during the year. It would be inappropriate, according to the taxpayer, to allocate the deduction to foreign source income because it does not relate to foreign source income producing activities engaged in by the executives during the taxable year in issue; and

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[1] A nonqualified stock option is one that is not governed by I.R.C. §§ 421 and 422. Centel Communications v. Commissioner, 920 F.2d 1335, 1344 n.7 (7th Cir. 1990).

(2) It does not directly relate to activities of the taxpayer which produced foreign income. The reportable compensation (and corresponding deduction) amounts from its stock options are attributable to the perceived increase in the value of the publicly traded shares by those buying and selling the stock, not to the production of foreign source income.

ISSUE

Whether a deduction related to stock options under I.R.C. § 83 should be allocated between domestic and foreign source income when domestic-based key employees who exercised the stock options also supervised the taxpayer's foreign branch operations that produced the foreign source income.

ANALYSIS

Section 83 of the Internal Revenue Code provides rules for taxation of property transferred in connection with the performance of services. If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of such property over the amount (if any) paid for such property shall be included in the gross income of the person who performed the services. I.R.C. § 83(a). In addition, section 83(h) allows a deduction to the employer under section 162 in an amount equal to the amount included under section 83(a) in the gross income of the person who performed such services. I.R.C. § 83(h). The regulations include past, present or future services in its definition of "property transferred in connection with the performance of services." Treas. Reg. § 83-3(f). The primary impetus behind the enactment of section 83 was to equate the tax treatment of restricted stock plans[2] involving employers and employees to the tax treatment accorded other types of deferred compensation arrangements. Centel Communications Co., Inc. v. Commissioner, 92 T.C. 612, 627 (1989), aff'd, 920 F.2d 1335 (7th Cir. 1990).

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[2] A restricted stock plan, generally, is an arrangement under which an employer transfers stock to one or more of his employees (often without the payment of any consideration), where the stock is subject to certain restrictions which affect its value. Centel Communications Co., Inc. v. Commissioner, 92 T.C. 612, 627 (1989), aff'd, 920 F.2d 1335 (7th Cir. 1990). Some stock options in the instant facts included restrictions.

With respect to the taxpayer's first argument, above, the taxpayer and the Service agree that section 83 applies to the exercise of the stock options herein. Insofar as section 83 explicitly applies to property transferred "in connection with performance of services," the taxpayer apparently agrees that the executives received section 83 stock option value as compensation. The applicable regulations and legislative history are clear that such options are deferred compensation and apply to not only past, but present and future services. It is apparent that the option value should be treated as compensation like the employee salaries in the year the option was exercised. The taxpayer deducted the allowable expense of the exercised stock options during the year they were exercised and, as such, cannot argue that the same is not compensation to its executives for the same year.

While the taxpayer deducted the stock option value pursuant to section 83, it also argues that it should not be allocated to foreign source income like the key employee salaries because it does not directly relate to activities of the taxpayer which produced foreign income, citing Treas. Reg. § 1.861-8(b)(1) and F.W. Woolworth Co. v. Commissioner, 54 T.C. 1233 (1970), nonacq., 1971-2 C.B. 4. According to the taxpayer, the reportable compensation (and corresponding deduction) amounts from its stock options are attributable to the perceived increase in the value of the publicly traded shares by those buying and selling the stock, not to the production of foreign source income. In essence, the taxpayer contends that because its deduction from exercised stock options is not directly related to foreign income producing activities, the full deduction should be allocated to domestic source income by default. We do not agree.

Section 861(a) of the Internal Revenue Code lists the items of gross income to be treated as income from sources within the United States. Section 861(b) provides that from the gross income from sources within the United States, there shall be deducted the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of any such deduction which cannot definitely be allocated to some item or class of gross income. I.R.C. § 861(a) and (b). The Code does not provide that a taxpayer may allocate the full amount of a deduction to domestic source income because it cannot be definitely allocated to a specific income item.

Section 1.861-8(a)(2) of the regulations provides in part that the taxpayer is required to allocate deductions to a class of gross income and, if necessary, apportion deductions within a class of gross income between the "statutory grouping of gross income" and the "residual grouping of gross income. Deductions

which are not definitely related to gross income are ratably apportioned to all gross income. Treas. Reg. 1.861-8(a)(2). For purposes of determining taxable income from foreign sources in order to apply the foreign tax credit rules, statutory groupings of gross income are the separate gross incomes from sources within each foreign country. Residual grouping is the aggregate of gross income from sources within the United States. Treas. Reg. § 1.861-9(a)(4). Under section 1.861-8(b)(1) of the regulations, "some deductions are treated as not definitely related to any gross income and are ratably apportioned to all gross income." Treas. Reg. § 861-8(b)(1).

Gross income to which a specific deduction is definitely related is referred to as a "class of gross income" and may consist of one or more items of gross income. The rules emphasize the factual relationship between the deduction and a class of gross income. In allocating deductions, it is not necessary to differentiate between deductions related to one item of gross income and deductions related to another item of gross income where both items of gross income are exclusively within the same statutory grouping or exclusively within the residual grouping. Treas. Reg. § 1.861-8(b)(1). A deduction shall be considered definitely related to a class of gross income and therefore allocable to such class if it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived. Where a deduction is incurred as a result of, or incident to, an activity or in connection with property, which activity or property generates, has generated, or could reasonably have been expected to generate gross income, such deduction shall be considered definitely related to such gross income as a class. Treas. Reg. § 1.861-8(b)(2). A deduction shall be considered definitely related to a class of income if it is incurred "in whole or in material part as a result of, or incident to, the activities from which such income is derived." F.W. Woolworth v. Commissioner, 54 T.C. 1233, 1270 (1970), nonacq., 1971-2 C.B. 4. 1270.

The taxpayer herein has not argued, nor has it provided any facts that would suggest its stock option deduction is definitely related to United States source income versus foreign source income, as residual and statutory gross income groups, respectively. Through the application of section 83, the stock option deduction was incurred incident to, or in connection with a property or activity from which such income is derived. The stock option was provided to key employees in connection with the performance of their services, and the value was computed in accordance with section 83. The taxpayer allocated the same key employees' salaries between foreign and domestic source income; we see no reason why the deduction for their incidental

compensation of stock options should not be similarly allocated.

Even if a deduction is not definitely related to any gross income, the regulations require that a deduction must be apportioned ratably between the statutory groupings of gross income and residual income. The amount apportioned to each statutory grouping shall be equal to the same proportion of the deduction which the amount of gross income in the statutory grouping bears to the total amount of gross income. The amount apportioned to the residual grouping (income from within the United States) shall be equal to the same proportion of the deduction which the amount of the gross income in the residual grouping bears to the total amount of gross income. Treas. Reg. § 1.861-8(c)(3). This regulation further illustrates that the taxpayer should not allocate full amount of the stock option deduction to gross income within the United States.

The taxpayer's reliance on Woolworth is misplaced. In Woolworth, the corporate petitioner had allocated executive officers' earnings and pension costs to income of its foreign branch stores which were under the supervision of its domestic headquarters. Compensation of the petitioner's store managers was based on profits generated by the individual store. Accordingly, the petitioner treated its foreign branch stores on the same basis as its United States stores in allocating a portion of the petitioner's executive office expense and other general expenses to such stores for services rendered. The question was not whether these costs should be allocated between foreign and domestic income, but whether the method of allocation employed by the petitioner was consistent and reasonable. The Tax Court found that it was. F.W. Woolworth v. Commissioner, 54 T.C. 1233, 1270-71 (1970), nonacq., 1971-2 C.B. 4.

After reviewing the regulations and the proposed regulations, the Tax Court applied the following useful tests regarding the allocation of a deduction: If a deduction is not definitely related to any item or class of income, it should be properly apportioned between domestic and foreign source income. A deduction definitely related to the taxpayer's domestic source income obviates the need for any allocation between domestic and foreign source income. Woolworth, 54 T.C. at 1272. As discussed above, our taxpayer did not contend that the deduction in question definitely related only to its domestic source income and, therefore, it cannot rely on Woolworth to argue it is not required to allocate.

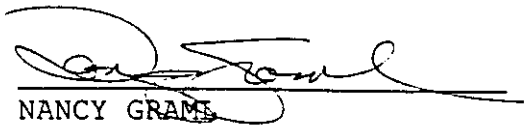
While Woolworth did not involve the allocation of the section 83 stock option deduction, such expense is similar to the executive office pension cost in the case. Also, both the

Woolworth petitioner and our taxpayer supervised its foreign branches from their domestic office. The result in Woolworth may have been different if the petitioner's executive pension costs were incurred for domestic executives who supervised only its domestic offices, rather than foreign branches or controlled foreign corporations. In this situation, a taxpayer could possibly show that such costs were definitely related only to domestic source income. We emphasize that whether a deduction is definitely related to a class or source of income is factual.

Based on the given facts, it is clear that our taxpayer should allocate the stock option deduction between foreign and domestic source income. If the taxpayer and Service subsequently agree to our conclusion, the parties have agreed to the method of allocation of the stock option deduction; that is, it should be allocated by the same method as the executive salaries: the percentage of foreign rig cost to total rig cost. In a private letter ruling, the Office of Chief Counsel advised the taxpayer to allocate its stock option deduction between foreign and domestic source income depending upon where the services giving rise to the income were performed. The deduction should be apportioned on a time basis, pursuant to Treas. Reg. § 1.861-4(b)(applicable to compensation for labor or personal services), unless some other basis more correctly reflects the source of income under the facts and circumstances of the case. Priv. Ltr. Rul. 90-37-008 (May 29, 1990). Our taxpayer kept no time records that allocated the percentage of time spent by its executives supervising its foreign branch operations. We would therefore endorse the agreed allocation method so long as the Service believes it is consistent, reasonable and best reflects the source of income under the circumstances.

If we may be of further assistance, please do not hesitate to call me at 281-721-7358.

BERNARD B. NELSON
District Counsel

By: 
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